No. 290

In the Supreme Court of the United States

October Term, 1952

Ernest A. Watson and M. Gladys Watson,
petitioners

v.

Commissioner of Internal Revenue

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT

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BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Tax Court (R. 19–50) and the dissenting opinion (R. 50–55) are reported at 15 T. C. 800. The opinion of the Court of Appeals (R. 130–134) is reported at 197 F. 2d 56.

JURISDICTION

The opinion of the Court of Appeals was entered on May 29, 1952. (R. 134.) The petition for a writ of certiorari was filed on August 25, 1952, and was granted on December 8, 1952. (R. 135.) The jurisdiction of this Court is conferred by 28 U. S. C., Section 1254.

QUESTION PRESENTED

The taxpayer was in the business of growing and selling citrus fruits. During the taxable year she sold her interest in a grove on which there was a large crop of oranges which had not reached full maturity. A large portion of the purchase price was attributable to the value of the existing orange crop.

The question is whether, to the extent that the taxayer's profit is attributable to the existing crop, the gain is taxable as ordinary income, as the Court of Appeals and the Tax Court held, or whether it is taxable as capital gain, as the taxpayer contends.

STATUTE INVOLVED

The applicable provisions of the statute involved are set forth in the Appendix, *infra*, pp. 47–49.

STATEMENT

The facts, as found by the Tax Court, may be summarized as follows:

In 1944, the taxpayer and her two brothers each owned an undivided one-third interest in a 115-acre tract of land (known as the Dofflemyer ranch) consisting of a 110-acre navel orange grove and a 5-acre peach orchard situated near Exeter, Tulare County, California, together with the improvements and equipment. From and after January 1, 1942, the taxpayer and her brothers had operated the ranch under a partnership agreement. (R. 20–21.)

In May or June, 1944, the taxpayer and her brothers listed with H. C. Balaam, a local real estate agent, the Dofflemyer ranch and an 80-acre vineyard with a packing-house on it for sale at a lump sum price of $329,100. After attempting to sell the properties, Balaam obtained an offer of $132,000 for the vineyard property. Thereupon, the taxpayer and her brothers withdrew the vineyard from sale and agreed that the asking price for the ranch should be $197,100, or the difference between the asking price for all the properties and the amount of the offer for the vineyard property. (R. 21.)

In his efforts to sell the ranch, Balaam, in June, 1944, contacted J. W. C. Pogue; Pogue had lived in the Exeter vicinity all of his life. He had been the owner of citrus fruit property, and had been in the citrus fruit business since 1907. Since the middle 1920's he had owned property adjacent to the ranch. Before reaching a decision on the matter, Pogue desired to wait in order to determine as accurately as possible what the orange crop would be, and also wanted to have the taxpayer and her brothers bear as much of the production costs of the crop as possible. (R. 21.)

Pogue examined the production records of the Dofflemyer ranch for the preceding year broken down into the various sizes of oranges and the quantity of culls. He went over the property at different times with men from his organization for the purpose of estimating what the orange crop

would be. After having estimated a crop of possibly 80,000 loose boxes of oranges and discounting that amount to 70,000 boxes to be safe, and after considering orange market conditions current in 1944, and estimating that the proceeds from the Dofflemyer orange crop would net about $120,000 after providing for further cultivation costs, picking, etc., Pogue, during the first part of August, decided to buy the ranch at the asking price of $197,100. On August 10, 1944, Louis L. Dofflemyer, who personally had been supervising the ranch since 1913, and was thoroughly familiar with it, estimated that the crop of oranges on the trees would produce 70,000 loose boxes. On the same day, August 10, 1944, an agreement was entered into between the taxpayer, her brothers, and Pogue, whereby Pogue agreed to buy the ranch for $197,100, $10,000 cash being paid at that time and $187,100 being payable on or before September 1, 1944. The sellers were to pay all operating costs to September 1, 1944, and taxes and insurance were to be prorated to that date. The proceeds from the peach crop on part of the ranch which was then being harvested went to Pogue who was to bear all expense of harvesting. The growing crop of oranges on the trees also went to Pogue with the land. On or about September 1, 1944, Pogue completed payment for the ranch. The principal reason that Pogue purchased the ranch for $197,100 was that he estimated he would realize the net amount of $120,000 from the sale

of the orange crop, and then would be able to sell the ranch for more than the difference between the purchase price and the proceeds from the sale of the crop. He considered that the selling price of $197,100 for the ranch with the equipment and the growing crop of oranges was below the market value of the properties. (R. 21–23.)

When navel oranges bloom in the spring, the small fruit forms on the trees. During May and June, particularly during the latter month, a considerable portion of the small fruit thus formed drops from the trees. After that has occurred, usually around July 1 in the Exeter area, the orange crop is said to become "set." Navel oranges in the Exeter area generally mature and are ready for picking early in November. From the time the crop is "set" until it is picked and marketed, navel oranges are subject to various types of scale and pests, which, if not controlled, may damage the fruit and render it unmarketable. However, losses from scale and pests on groves which are operated by experienced growers and which receive ordinary care do not present any substantial problem commercially. The Dofflemyer ranch losses from such sources for 1943 amounted to approximately two percent of the total crop. Under normal conditions a grove which has generally produced large-sized fruit will produce that type of fruit each year. After the first of September there is little

that is likely to happen to the quality of the fruit. It is possible for one experienced in orange-growing and familiar with a given grove to estimate with a reasonable degree of certainty during August and September what the production of the grove for the year will be. (R. 26–27.)

The most damaging element to an orange crop in the Exeter area is frost. Generally, the frost period extends from about December 10 to January 15 or 20. In a normal year there are usually a few nights when it is necessary to take some means of protection against frost. Prior to completion of the installation of wind machines on the Dofflemyer ranch in 1939, frosts were severe enough on an average of once in every four years to cause damage to the orange crop. Thereafter, and until the sale of the ranch in 1944, the wind machines provided protection from the frost that occurred and no frost damage was sustained. On an average, severe frosts or freezes occur about once in ten years and some damage can be expected despite the use of protective devices in the grove. However, the wind machines and smudge pots on the Dofflemyer ranch were sufficient to provide adequate protection against frost damage except in periods of record-breaking low temperatures of long duration. Usually, a large part of the navel orange crop is picked before a damaging frost is normally expected. Under the prorate system, which was in effect in 1944, and

under which an orange grove owner picks only an allotted quantity of oranges each week, the period for picking a crop lasts from eight to ten weeks so that some of the matured fruit is exposed to frost risks for a longer time. However, matured oranges are less susceptible to frost damage than unmatured oranges. During the frost period of 1944–1945, there was not enough frost to do any damage to the navel orange crop. During the 1948–1949 period, the Exeter area experienced the worst freeze in the history of the weather bureau for northern California. That season, Pogue did not pick 25 acres of oranges on the Dofflemyer ranch because of damage from freezing. The last previous freeze occurred in 1937. A factor influencing W. Tood Dofflemyer to sell the ranch was the possibility of a freeze during the 1944–1945 season, which would render some portion of the then growing orange crop valueless. While there are risks or hazards in the growing of navel oranges, they are no greater in that industry than they are in many other agricultural or fruit-growing operations. (R. 27–28.)

The cost of cultivation in 1944 of the orange crop to September 1 was \$16,020.54, and was taken as an expense deduction by the operating partnership in its return of income for 1944. (R. 29.)

During the years 1943 and 1944, the market for oranges was at a very high level, with ceiling

prices being in effect for the oranges produced in those years. Growers could expect to receive the ceiling price, plus premiums under certain conditions for first-grade fruit, the ceiling price for the balance of their first-grade fruit and some second-grade fruit, and an over-all average of near ceiling price for all marketable fruit. The average selling price of the oranges produced on the Dofflemyer ranch in 1943 was $1.71 per loose box, picking and hauling costs were 23 cents per box, thus indicating a value on the tree at maturity of $1.48 per box. (R. 29.)

Before the prorate system of picking and marketing oranges became effective, cash buyers of unmatured and matured orange crops on the trees operated more extensively than they have since. It was not uncommon in the Exeter area, before the beginning of the prorate system, for purchases of unmatured orange crops on the trees to be made during September, and in at least one instance, a purchase was made as early as July. Because of the large profits which cash buyers expect to realize from their purchases, owners who sell to them do not realize as much from their crops as if they held them and sold through consignment organizations. More than 95 percent of the orange crops in the Exeter area are marketed through such organizations. (R. 29–30.)

On or about September 1, 1944, Pogue had estimates or appraisals made of the Dofflemyer

property by three persons familiar with orange grove values in the Exeter area. On the basis of these and an appraisal made by himself, he allocated on his books $120,000 of the purchase price of the ranch to the navel orange crop on the trees, $23,000 to the 115 acres of land, $38,600 to the 110 acres of orange trees, $1,000 to the five acres of peach trees, $6,000 to the wind machines, $3,000 to the pumping plants, and $3,000 to the trucks, tractors, etc., on the property. (R. 30.)

Beginning in November, 1944, the orange crop on the Dofflemyer ranch was harvested, and produced 74,268 loose boxes from which Pogue received gross proceeds of $146,000. Cultivation costs from September 1 to maturity, plus picking and hauling costs, amounted to approximately $20,000, thus resulting in a net return of about $126,000 from the sale of the crop. (R. 30.)

In her joint income tax return the taxpayer reported the sale of her one-third interest in the Dofflemyer ranch on September 1, 1944, at a net gain of $48,819.82, fifty percent of which, or $24,-409.91, was included in taxable income as a long-term capital gain. No portion of the taxpayer's one-third share of the selling price of the ranch was allocated to the growing oranges on the trees at the time of the sale. The Commissioner determined that of the reported net gain of $48,-819.82 from the sale, $40,833.33 represented the taxpayer's one-third share of the fair market

value of the growing crop of oranges on the trees, and that said amount constituted ordinary income and not capital gain. (R. 30–31.)

The Tax Court found that $40,000 of the total price received was allocable to the growing crop on the trees. (R. 31.) It held that the taxpayer's portion of this was taxable as ordinary income. (R. 31–50.) Two judges dissented. (R. 50–55.) The decision of the Tax Court was affirmed by the Court of Appeals. (R. 130–134.)

SUMMARY OF ARGUMENT

The taxpayer was in the business of growing and selling oranges. During the taxable year, she sold her interest in a citrus grove after the time when the current orange crop had become "set", but prior to the time when the fruit would reach full maturity. More than 20 percent of the purchase price paid for the entire property was attributable to the value of the growing crop of fruit which was then on the trees. The Court of Appeals and the Tax Court correctly held that the portion of the profit which was derived on account of the existence of the growing fruit was taxable as ordinary income, rather than at capital gain rates as contended by the taxpayer.

The growing fruit, as the taxpayer admits, does not come within the definition of a capital asset. Furthermore, an existing crop does not qualify as property used in the trade or business and is not entitled to capital gain treatment under Section

117 (j) of the Internal Revenue Code. The growing fruit, as the Tax Court found, was being held by the taxpayer primarily for sale to customers in the ordinary course of her trade or business, and Section 117 (j) (1) expressly excludes such property from the benefits of capital gain treatment.

Crops grown by farmers have long been considered for tax purposes as being different from the land on which they are grown. They constitute the source of the ordinary business income earned by farmers. Consequently, when Congress extended capital gain treatment in Code Section 117 (j) to sales or exchanges of property used in a trade or business and excepted from that section property which is inventorial or which is held for sale to customers, it drew a distinction between property, like machinery and plant, which is employed in a business, and property which is normally sold to produce ordinary business income. The land and the fruit-bearing trees owned by the taxpayer come within the former class of property, but the existing crop comes within the latter. The statute did not contemplate that gain from the sale of a farmer's crops, whether sold before or after maturity and whether sold to one or more purchasers, should be taxed at preferential capital gain rates.

The taxing statute employs its own standard of what assets should be considered as capital assets or should be taxed at capital gain rates. It is, accordingly, quite immaterial whether Cali-

fornia law would regard the sale of a citrus grove with a growing crop of fruit as being an indivisible sale of real property. In the present case, the sale of the citrus grove involved divisible elements under the taxing statute; the considerable portion of the profit which was realized by the taxpayer and which the Tax Court found was attributable to the existing crop of oranges, must be taxed as ordinary income.

The meaning of Code Section 117 (j), as it existed during the taxable year and as applicable to the present case, is emphasized by subsequent Congressional amendments which, for future years, expressly provided that the benefits of Section 117 (j) should be extended to a sale of farm land with an unharvested crop. Indeed, in extending these benefits for future years, Congress did so only by removing from such taxpayers the right, which they previously enjoyed, of deducting the expenses of the unharvested crop from their ordinary income.

There is an alternative reason for sustaining the decision of the Court of Appeals. Even if the growing crop could be classified as property used in the taxpayer's trade or business under Code Section 117 (j), the benefits of that section would not be available to the taxpayer since it is operative only with respect to property which is used in a trade or business and which has been held by a taxpayer for more than 6 months. Since, as the Court of Appeals ruled, the existing crop

of oranges had not been held by the taxpayer for 6 months at the time when the property was sold, she is not entitled to capital gain treatment on the portion of the profit which was attributable to the existing crop.

ARGUMENT

I

THE SALE OF A CITRUS GROVE, TOGETHER WITH A GROWING CROP OF FRUIT, RESULTS IN THE REALIZATION OF ORDINARY INCOME TO THE EXTENT THAT PROFIT IS ALLOCABLE TO THE VALUE OF THE GROWING FRUIT

A. *Introductory.*—The single issue for decision in this case is whether, on the sale of an orange grove by one whose business is that of growing and selling oranges, the profit attributable to the growing crop of fruit is taxable as ordinary income rather than at capital gain rates.[1] The Tax Court and the Court of Appeals were correct, we believe, in deciding that the profit must be classified as ordinary income under the taxing statute. While a contrary result was reached in *Owen* v. *Commissioner*, 192 F. 2d 1006 (C. A. 5th), and in *McCoy* v. *Commissioner*, 192 F. 2d 486 (C. A. 10th), the Government respectfully submits that those cases were erroneously decided.

[1] During the taxable year in controversy, gains from the sale of capital assets, held for more than 6 months, were taxed at a preferential rate which would not exceed 25 percent of the gain. Section 117 (b) and (c) (2), Internal Revenue Code, as amended by Section 150 (c) of the Revenue Act of 1942, c. 619, 56 Stat. 798.

Since the proper answer to the question depends upon the meaning of terms employed in the statute, we start with the definition of "capital assets" in Code Section 117 (a) (1) (Appendix, *infra*, p. 47). That section defines capital assets to include all property held by a taxpayer, and then excludes from the definition (1) stock in trade or inventorial property; (2) property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business; (3) property used in the trade or business which is subject to deductions for depreciation; (4) certain non-interest bearing, governmental obligations issued on a discount basis; and (5) real property used in the taxpayer's trade or business.

It is readily apparent that none of the property elements which were transferred when the taxpayer sold her interest[2] in the orange grove comes within the statutory definition of a capital asset. The land itself falls within the exclusion of real estate used in the trade or business. The fruit-bearing trees, being depreciable in nature, come within the exclusion of depreciable property used

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[2] The taxpayers are husband and wife who filed a joint return. Since the interest in the property was owned by the wife, she will be referred to as the taxpayer.

The taxpayer owned a one-third interest in the property, and the case involves the proper tax on her share of the profit realized. However, for purposes of simplicity, the issue will be dealt with as though she were the sole owner of the property.

in the trade or business. Both the land and the trees, because they are property used in the trade or business, are entitled to the benefits of capital gain treatment under the provisions of Code Section 117 (j) (Appendix, *infra*, pp. 47–49), discussed at pages 19–22, *infra*. The growing fruit is excluded from the definition of a capital asset, we contend, because it was being held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, and, for the same reason, it does not qualify for capital gain treatment under Section 117 (j), since that section, like Section 117 (a) (1), excludes property which is being held for that purpose.

The taxpayer does not contend that the definition of "capital assets" in Section 117 (a) (1) is applicable. Her claim to preferential capital gain treatment on the profit derived from the sale of the growing fruit is based on the provisions of Code Section 117 (j) (2) which considers the gains (to the extent that they exceed losses) from sales or exchanges of "property used in the trade or business," and held for more than 6 months, as gains from the sale or exchange of capital assets held for more than 6 months.[3] For the purpose of that subsection, Section 117 (j) (1) defines "property used in the trade or business"

[3] To the extent that gains from the sale or exchange of such property exceed losses, the excess is taxable at the preferential rate of 25 percent applicable to long-term gains from the sale or exchange of capital assets. See fn. 1, *supra*, p. 13.

to include depreciable property used in the trade or business which has been held for more than 6 months, and real property used in the trade or business which has been held for more than 6 months, but excludes property which is inventorial or which is held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. The taxpayer asserts that the growing fruit must be regarded as "real property" because its character is inseparable from that of the trees and because, as it is further contended, the fruit is regarded as real property by California law; for that reason, the taxpayer claims that Section 117 (j) (2) is applicable to extend capital gain treatment not only to the profit attributable to the sale of the land and the trees, but also to the portion of the profit realized on account of the existing crop of fruit which the purchaser acquired on the sale.

The short answer to the taxpayer's ultimate contention, as given by both of the courts below, is that the growing crop, whether it be regarded as real property or as personal property, does not fit the Section 117 (j) (1) definition of "property used in the trade or business" for the reason that, to the taxpayer, whose normal business activity consisted of growing and selling oranges, the existing crop was "property held by the taxpayer primarily for sale to customers in the ordinary course of [her] * * * trade or business." Further, as the Court of Appeals

ruled, the fact that the existing crop had not been held for more than six months was an additional reason why the gain was not taxable at preferential rates under the provisions of Section 117 (j).

B. *Section 117 (j), Internal Revenue Code, Did Not Extend Capital Gain Treatment to Growing Crops Sold Prior to 1951. A Farm Crop Is Not Property Used in the Trade or Business.*—The legislative history of the capital gains provisions and of Section 117 (j), which extended capital gain treatment to certain property used in the trade or business, demonstrates the error of the taxpayer's contention that Congress intended to tax as capital gain the profit derived from a growing crop of fruit in the circumstances of this case. Such preferential taxation was not permitted by the statute prior to the express amendment of Section 117 (j) made by Section 323 of the Revenue Act of 1951, c. 521, 65 Stat. 452, which is in terms applicable only to taxable years beginning with 1951 and which is discussed, *infra*, pp. 38–42.

Special provisions respecting the taxation of gains and losses from capital assets first appeared in Section 206 of the Revenue Act of 1921, c. 136, 42 Stat. 227. *Burnet* v. *Harmel*, 287 U. S. 103, 105–106; H. Rep. No. 350, 67th Cong., 1st Sess., pp. 10–11 (1939-1 Cum. Bull. (Part 2) 168, 176); S. Rep. No. 275, 67th Cong., 1st Sess., pp. 12–13 (1939-1 Cum. Bull. (Part 2) 181,

189-190). While, during the course of years, there have been important changes in the tax treatment of capital gains and losses, and in the precise definition of what constitutes a capital asset, the general approach has been one of according favorable tax treatment to increments in value accruing to property held as an investment or for non-business purposes, as distinguished from gains which result from a taxpayer's ordinary business activity. *Rollingwood Corp.* v. *Commissioner,* 190 F. 2d 263, 266-267 (C. A. 9th). See Miller, *The "Capital Asset" Concept: A Critique of Capital Gains Taxation,* 59 Yale L. J. 837 (Part I), and 1057 (Part II) (1950).

One of the important changes in definition was made by Section 117 (a) (1) of the Revenue Act of 1938, c. 289, 52 Stat. 447, which excluded from the term "capital assets" property used in a trade or business which was of a character which would be subject to the allowance for depreciation. The change was stated to be in recognition of "the principle that gains or losses realized upon the sale, exchange, or other disposition of such property are business gains or losses * * *." H. Rep. No. 1860, 75th Cong., 3d Sess., pp. 7, 34-35 (1939-1 Cum. Bull. (Part 2) 728, 732-733, 752-753).

As a consequence of the 1938 change in definition, where a taxpayer owned real property on which depreciable improvements were erected, and such property was used in a trade or busi-

ness, the land was classified as a capital asset, but the improvements, being depreciable, were not. Gain or loss on the sale of such property was required to be apportioned between the land and the improvements.

This is the background of the addition of Code Section 117 (j) made by Section 151 (b) of the Revenue Act of 1942, c. 619, 56 Stat. 798. As reported to and passed by the House of Representatives, the 1942 Revenue Bill would have added "buildings and similar real property improvements" used in the trade or business to the definition of capital assets in Section 117 (a) (1) and would have also extended capital gain treatment (to the extent that gains exceeded losses) to all other depreciable property used in a trade or business. H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 52–53, 53–54 (1942–2 Cum. Bull. 372, 414, 415).[4]

[4] In explaining the proposed amendment, the House Ways and Means Committee stated (H. Rep. No. 2333, *supra*, pp. 52–53, 53–54 (1942–2 Cum. Bull. 372, 414, 415)):

"Your committee has revised the definition of capital assets, so that buildings and similar real estate improvements are included within the definition. Under the present law, buildings and similar real estate improvements are not treated as capital assets, because they are subject to depreciation allowances. The present law not only results in unfairness to the taxpayer but also in considerable administrative difficulty. For example, if an apartment house in [is] sold, under the present law, it is necessary to separate the land from the building for income-tax purposes. This is because the gain allocable to the building is subject to the normal and surtax rates, while the gain allocable to the land is subject to the capital gain rate. On the other hand, if the taxpayer suffers a loss on the building, such loss is treated as an ordi-

The Senate version, which was that ultimately adopted, was to remove real property used in a trade or business from the definition of a capital asset under Code Section 117 (a) (1) but to add Code Section 117 (j) so as to extend capital gain treatment (to the extent that gains exceed losses)

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nary loss and deductible in full from ordinary income, whereas if he suffers a loss on the land, that is treated as a capital loss and subject to the capital loss limitations. It is very difficult to allocate the capital gain or loss between the land and the buildings. Accordingly, your committee has changed the rule of existing law, so that both the land and the building, or similar real estate improvements, are treated as capital assets.

* * * * * *

"Under existing law, the gain or loss from the sale or exchange of depreciable property is not treated as a capital gain or capital loss, but as an ordinary gain or an ordinary loss. This rule was originally inserted as a relief provision to enable corporations to have the full benefit of a loss from the sale of machinery, instead of being limited by the capital loss provisions, which would permit it only a certain percentage of the loss. It was felt at that time that the taxpayer should not be denied the full loss because it sold the property at a loss instead of abandoning the property. While this rule provided relief in case a loss was realized, it appears that many taxpayers are able to dispose of their depreciable property at a gain over its depreciated cost. To treat such a gain as an ordinary gain will result in an undue hardship to the taxpayer. For example, a taxpayer sells certain trawlers used in his business to the Government. If the gain from the sale is regarded as an ordinary gain, it may result in the taxpayer receiving practically nothing for his property. Another example is where the proceeds of insurance on destroyed property exceed the cost of the property. The existing law treats such gain as ordinary income. The gain or loss resulting from the involuntary conversion of property into other property or money is also treated as an ordinary gain or loss. The theft of an article, which is

to all depreciable and real property used in the trade or business which was held for more than six months and which was not inventorial or was not being held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 50, 119, 120 (1942-2 Cum. Bull. 504, 545, 594).[5] Losses from the sale or exchange of such

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insured, is an example in point. Your committee has provided the following solution for this problem:

"(a) If the total gains in such cases exceed the losses, such gains shall be considered as gains from the sale or exchange of capital assets held for more than 15 months. Buildings and similar real property improvements are not included in this provision, unless gains or losses therefrom result from an involuntary conversion. This is because buildings and similar real property are treated under a different provision of the bill. In determining whether the gains exceed the losses, 100 percent of such gains or losses are taken into account. In the case of involuntary conversions, the existing law is amended to provide that the loss shall be recognized upon the conversion.

"(b) If the gains do not exceed the losses in such cases, such gains and losses will be treated as ordinary gains and ordinary losses instead of capital gains or capital losses. Where the losses exceed the gains, the excess loss will be deductible from income as an ordinary loss."

[5] The Senate Finance Committee agreed that it was desirable for land and improvements to have the same character, but considered also that all property used in the trade or business should be treated alike and that no distinction should be made between the land and its improvements and other property used in the trade or business. It stated (S. Rep. No. 1631, *supra*, p. 50 (1942-2 Cum. Bull. 504, 545)):

"(2) Under the House bill losses from the sale of real property and buildings were treated as capital losses, even though the property was used in the trade or business. Your committee has changed this rule by taking buildings and real

assets, however, were not made subject to the limitations applicable to capital losses.

In determining the applicability of Section 117 (j) to the circumstances of this case, it is important to emphasize that Congress, while granting

estate used in the trade or business of the taxpayer out of the definition of capital assets, and applying to them the same rule which the House bill applies to gains and losses from involuntary conversions from the sale or exchange of certain depreciable property. If the total gains exceed the losses, such gains will be considered as gains from the sale or exchange of capital assets held for more than six months. If the gains do not exceed the losses, such losses will be treated as ordinary gains and ordinary losses instead of capital gains and capital losses.

"It is believed that this Senate amendment will be of material benefit to businesses which, due to depressed conditions, have been compelled to dispose of their plant or equipment at a loss.

"The bill defines property used in a trade or business as property used in the trade or business of a character which is subject to the allowance for depreciation, and real property held for more than 6 months which is not properly includible in the inventory of the taxpayer if on hand at the close of the taxable year or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. If a newspaper purchased the plant and equipment of a rival newspaper and later sold such plant and equipment at a loss, such plant and equipment, being subject to depreciation, would constitute property used in the trade or business within the meaning of this section."

It also said (S. Rep. No. 1631, *supra*, p. 119 (1942-2 Cum. Bull. 504, 594)):

"Subsection (a) of this section, in the House bill, included real property improvements used in the trade or business and subject to an allowance for depreciation, within the definition of "capital assets" in section 117 (a), so that such improvements would have the same character for tax pur-

capital gain treatment to sales or exchanges of property used in a trade or business, like plant or equipment (see fn. 5, *supra*, p. 22), carefully excepted from this classification property which was inventorial or which was held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. The same differentiation had already existed in Section 117 (a) (1), which excludes from the definition of a capital asset property which is inventorial or which is held primarily for sale to customers. In other words, Congress continued to withhold capital gain treatment with respect to a taxpayer's stock in trade since such property, in contrast with that which is *used* in a trade or business, is *sold* in the ordinary conduct of the business and the sale proceeds are the normal source of ordinary business profits. Cf. *Fields* v. *Commissioner*,

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poses as the land on which they stand. While your committee believes it desirable for the land and the improvements to have the same character, it considers it more appropriate to treat all property used in the trade or business alike, and not to distinguish between land and other property used in the trade or business. Accordingly, this subsection has been changed to provide that land used in the trade or business is not within the definition of "capital assets" in section 117 (a), and will therefore have the same character as improvements subject to an allowance for depreciation, which under existing law are excepted from that definition. In accordance with this policy, changes have also been made in subsection (b) of this section, relating to the treatment of gains and losses on the sale, exchange, and involuntary conversion of depreciable property, to subject to such treatment land used in the trade or business."

189 F. 2d 950 (C. A. 2d); *Rollingwood Corp.* v. *Commissioner*, 190 F. 2d 263 (C. A. 9th).[6]

There is nothing in the statutory language of Section 117 (a) (1) and (j), or in the legislative purpose of granting special tax consideration to capital assets and to property used in a trade or business, which even tends to support the taxpayer's argument that a growing farm crop was intended to be accorded this special tax preference. On the contrary, where crops are grown for sale, they are, as the Tax Court said (R. 46), the farmer's "stock in trade" and consequently are, in the statutory scheme, the opposite of capital assets and of property *used* in a trade or business.

The courts below, we believe, correctly applied the provisions of Section 117 (j). The taxpay-

[6] The exclusion from the definition of capital assets of "property held by the taxpayer primarily for sale in the course of his trade or business" was added by Section 208 (a) (8) of the Revenue Act of 1924, c. 234, 43 Stat. 253. The language was added (H. Rep. No. 179, 68th Cong., 1st Sess., p. 19 (1939-1 Cum. Bull. (Part 2) 241, 255))—

"to remove any doubt as to whether property which is held primarily for resale constitutes a capital asset, whether or not it is the type of property which under good accounting practice would be included in the inventory."

The words "to customers" in the "ordinary" course of his trade or business were added by Section 117 (b) of the Revenue Act of 1934, c. 277, 48 Stat. 680, and were explained as (H. Conference Rep. No. 1385, 73d Cong., 2d Sess., p. 22 (1939-1 Cum. Bull. (Part 2) 627, 632))—"making it impossible to contend that a stock speculator trading on his own account is not subject to the provisions of section 117." See *Gruver* v. *Commissioner*, 142 F. 2d 363, 368 (C. A. 4th).

er's land and grove trees, being the property used to produce the crop and not being held primarily for sale to customers, clearly constituted the property used in the taxpayer's trade or business; the land and trees, consequently, were entitled to the benefits of Section 117 (j). The existing crop of fruit, however, was not property used in the trade or business, for each annual crop was destined to be sold to customers in the ordinary course of the taxpayer's business and was the normal source of the business income which has always been taxed at ordinary income tax rates.

The fact that all the crop was sold to a single customer who acquired it along with the grove property does not alter the character of the gain realized by the taxpayer which was attributable to the growing fruit. Thus, in *Williams* v. *McGowan*, 152 F. 2d 570 (C. A. 2d), where the taxpayer sold his entire business and business property, it was held that each item of property embraced in the sale must be measured against the statutory standard. And, significantly, the stock in trade in *Williams* v. *McGowan*, though sold to the single purchaser of the business rather than to customers in the normal conduct of the business, was held to have resulted in ordinary income. See also *Grace Bros.* v. *Commissioner*, 173 F. 2d 170, 178 (C. A. 9th).

The taxpayer's argument that she was not in the business of selling immature fruit to customers does not really meet the test of the statute

so as to qualify the profit for capital gain treatment. The statute is not concerned with whether the property is actually sold to customers in the ordinary course of business. It excepts from capital gain treatment property which is "held" by the taxpayer primarily for sale to customers and, we submit, one who normally sells the crop at maturity, has held it for that purpose from its inception.[7] The sale of fruit to customers is the ultimate objective of the taxpayer's business, and the fruit could only have been held by the taxpayer for that purpose.

The Tax Court, it will be noted, found as a fact that the crop was being held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. (R. 47.) This conclusion is one which the Courts of Appeals have generally accepted as being primarily within the province of the fact finders. *Friend* v. *Commissioner,* 198 F. 2d 285, 287 (C. A. 10th); *King* v. *Commissioner,* 189 F. 2d 122, 124 (C. A. 5th), certiorari denied, 342 U. S. 829; *Harriss* v. *Commissioner,* 143 F. 2d 279, 281 (C. A. 2d); *Rubino* v. *Commissioner,* 186 F. 2d 304 (C. A. 9th), certiorari denied, 342 U. S. 814.

Moreover, no matter what the purpose for which the crop was held, the taxpayer cannot bring herself within the definition of Section 117 (j)(1) as an initial matter unless the crop was

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[7] See Miller, *The "Capital Asset" Concept: A Critique of Capital Gains Taxation,* 59 Yale L. J. 1057, 1083 (1950).

"used" in the trade or business and this, we submit, is a conclusion which would be altogether out of harmony with the concepts employed by Congress. The growing crop is not like the plant or equipment which Congress thought of as being used in a trade or business. See fn. 5, *supra*, p. 22.[8] The farmer's crop is no more "used" in the farming business than the products of a manufacturer are "used" in the manufacturing business. In the final analysis, the taxpayer was in the business of growing and selling oranges; the gain of $40,000 which was realized on the transfer of the existing, growing crop represents the very kind of business income which Congress intended to tax as ordinary income.

Crops grown by farmers have always been regarded, so far as federal tax matters are concerned, as a species of property quite different and distinct from the land on which they are grown. As early as 1920, in O. D. 714, 3 Cum. Bull. 49 (1920), it was ruled that where farm land is purchased and a growing crop is in existence, the purchaser, in calculating his profit after the crop has been harvested and sold, may deduct the appropriate part of the price attributable to the value of the growing crop which was acquired

[8] Treasury Regulations 111, promulgated under the Internal Revenue Code, Section 29.117-7, in describing the operation of Code Section 117 (j) uses the following as examples of property used in a trade or business: (1) machinery; (2) factory premises consisting of land and building; (3) land used as a storage lot for trucks; (4) a boat; (5) warehouse.

as an incidence of the purchase of the land. It was thus recognized that, though there was but a single sale of land together with growing crops, the purchaser had made two distinct investments with separable taxable incidents. His investment in the farm land was of a more permanent nature which would be used in his farming business. That investment could only be recouped on a future disposition of the land itself. However, to the extent that the total purchase price represented the cost of acquiring the growing crop, the purchaser was investing in the very type of property which would be sold in his business of farming, and the Bureau's ruling, recognizing the distinction, permitted that portion of the investment to be recouped in the tax computation at the time when the harvest was sold so as to permit an accurate reflection of his true business income.[9]

[9] In the context of the present case, the need to separate the elements involved in the sale is quite apparent. Thus, the orange crop which was in existence when the grove was purchased was ultimately sold by the purchaser for $146,000 which, after expenses of $20,000 incurred by him, resulted in a net return of $126,000. (R. 30.) We believe, contrary to the plain implications that follow from the taxpayer's argument, that the purchaser did not acquire indivisible elements in the sale, but that, to the extent that part of the purchase price represented the value of the growing crop which was distinct from the value of the land and of the fruit-bearing trees, that value ($40,000) should be deducted from the net return of $126,000 in determining how much gain he realized in selling the mature crop, so that only $86,000 would be taxable to him at ordinary income tax rates.

That there is a distinction between the fruit-bearing trees and the fruit crop is apparent in other respects. From an early time it was recognized that the fruit trees are depreciable property "used in the trade or business" of one who grows fruit for sale, so that the cost of the trees, together with the capital expenditures required to bring them to a productive state, are recoverable through allowances for depreciation. O. 797, 1 Cum. Bull. 130 (1919); Mim. 6030, 1946–2 Cum. Bull. 45; and Mim. 6030 (Supp. 1), 1948–1 Cum. Bull. 42; Section 29.23 (a)–11, Treasury Regulations 111, promulgated under the Internal Revenue Code, and corresponding provisions of prior Regulations beginning with Article 110, Treasury Regulations 62, promulgated under the Revenue Act of 1921; *Thompson & Folger Co.* v. *Commissioner*, 17 T. C. 722; *Redlands Security Co.* v. *Commissioner*, 5 B. T. A. 956. However, distinct from the capital expenditures incurred in connection with the trees are the expenses incurred in connection with the growing of each annual crop of fruit. The latter are deductible from gross income as business expenses because incurred in the farmer's business of growing and selling crops. Code Section 23 (a) (1) (A); Section 29.23 (a)–11, Treasury Regulations 111, *supra*. In this very case, the taxpayer and her brothers had deducted more than $16,000 of the expenses attributable to the growing of the 1944 crop and bringing it to

partial maturity. (R. 29.) The statute, we submit, never contemplated that the profit derived from the crop should be taxed at preferential capital gain rates, while the crop expenses (to which the taxpayer was concededly entitled) were being deducted from ordinary income.

From a practical viewpoint, moreover, there is a substantial difference between the farmer's crop and the property used to grow it. In that respect, the farming business is analogous to the manufacturing business, the land and trees here being similar to the machinery and equipment which the manufacturer uses to produce his products. These are the items of property which each uses in his trade or business and which Congress intended to cover by Section 117 (j). The growing crop, so far as the farmer is concerned, is similar to goods in process of manufacture, for each is ultimately destined to be sold to customers and to be the source of normal business profi . Such property was expressly excluded by Congress from any special tax considerations. The Tax Court, we believe, correctly summarized this when it observed (R. 45-46):

> That farmers, fruit growers, and the like regard, think of and deal with their crops, whether growing or mature, as being something apart from or other than the land itself, is, we think, so generally known and accepted as to require no discussion or amplification here. The crop is their stock

> in trade and from the time the fruit appears on the plant, vine, or tree, it is thought of in terms of the units by which it is measured for sale and of the anticipated prices per unit. In short, the primary purpose and objective of the farmer or fruit grower is the sale of his crop to some customer or customers. * * *

The particular facts of the present case emphasize the validity of these observations of the Tax Court. Thus, while the contacts with Pogue, ultimate purchaser, were made in May or June of 1944, he decided (R. 21) "to wait in order to determine as accurately as possible about what the orange crop would be * * *." It was only after he had examined the production records for the preceding year, and had inspected the property at different times to estimate the size of the present crop, and to predict what net proceeds could be realized from its sale, that Pogue decided to buy the property. The sale, which was consummated in August, took place after the crop had become "set." (R. 22.) Indeed, the Tax Court found as a fact that the reason why he was willing to pay the asking price was that (R. 23)—

> he estimated he would realize the net amount of $120,000 from the sale of the orange crop and then would be able to sell the ranch for more than the difference between the purchase price and the proceeds from the sale of the crop. * * *

It is clear that the price paid for the property was affected by the existence of the growing crop. Reviewing all the evidence, the Tax Court concluded (R. 44):

> That in the instant case the oranges, exclusive of the land, trees and improvements, did in fact constitute a distinct and important item or element in the lump sale which occurred, is not, in the light of the evidence, now open to question. * * *

If the sale had been earlier, before the crop had become set and before the earlier risks of the grower had passed, the price paid would by no means have been the same. And, we submit, in every such sale, to the extent that the growing crop possesses an ascertainable value, that value enters into the price paid for the entire property. No reasonable purchaser or seller could exclude this from consideration. Even the sellers here were dealing with the crop as something separate from the trees and land, for the Tax Court, summarizing the evidence, found (R. 45):

> On the basis of his experience that freeze years occurred in cycles, W. Todd Dofflemyer, who negotiated the sale, felt certain that the season of 1944-1945 would be a freeze year and desired to cash in before cold weather, letting the purchaser run the risk of crop loss due to frost. His testimony, in effect, was that if he had not thought there would be a crop loss due to frost, and had thought they would have

received ceiling price for the oranges, he would not have sold but would have held the property. In other words, all the parties to the sale did, in fact, regard the oranges as a crop of fruit on the trees, and not as trees on land. Pogue was buying oranges which he planned to harvest and sell to customers. Petitioner and her brothers were selling their crop of oranges for cash in hand, allowing to the purchaser the added revenue if they reached maturity without loss and the high prices continued.

The foregoing, quite clearly, refutes the taxpayer's assertion (Br. 17) that "In their dealings the sellers gave no recognition to the artificial severance of immature crop from trees which the Commissioner has proposed." It also refutes the taxpayer's broader assumption that (Br. 24), until such time as it has actually been picked, an existing growing crop cannot be differentiated from the non-existing crops of future years and merely represents an expectation of future income.

A successful citrus crop, as is true of other farm crops, moreover, is largely dependent on expenditures of money and labor in the form of cultivation. With personal efforts playing so large a part in the growing of a successful crop, it is clear that there has been no conversion of a capital asset or of property used in the business when the crop is sold, even though the sale takes place prior to maturity and even though the growing crop is sold together with the producing grove.

The Court of Appeals properly concluded that this was an additional reason why the capital gains benefit was not intended to be applicable to the sale of the growing crop, stating (R. 132):

> Since the purpose of capital gains relief is to avoid ordinary income taxation on the realization of values that have accumulated over a long period of time, we are re-enforced in our conclusion that the growing crop here is not entitled to the relief of § 117 (j). The value of the crop is largely the product of effort within the tax year and the periodic realization of income from the crop covers a short period approximating the tax year. *Rollingwood Corp.* v. *C. I. R., supra.*

C. *California Law Does Not Determine What Property Is Used In A Trade Or Business Under Code Section 117 (j).*—It is pertinent to observe that much of the taxpayer's argument is founded on the erroneous assumption that California law determines whether the growing crop is an inseparable part of the real estate and is to be considered as property used in the trade or business for the purposes of the Section 117 (j) (1) definition. It is well settled, however, that the concepts employed in the taxing statute are to be given a uniform, nation-wide application and that they are not controlled by local law except where Congress has so intended. *Burnet* v. *Harmel*, 287 U. S. 103, 110; *Founders General Co.* v. *Hoey*, 300 U. S. 268, 275; *Thomas* v. *Perkins*, 301

U. S. 655, 659; *Lyeth* v. *Hoey*, 305 U. S. 188, 194; *United States* v. *Pelzer*, 312 U. S. 399, 402–403; *Estate of Putnam* v. *Commissioner*, 324 U. S. 393, 395. Thus, in *Burnet* v. *Harmel, supra*, it was held that the question whether the execution of an oil and gas lease was to be taxed as the sale of a capital asset was not governed by concepts of local law which regarded such a lease as effectuating a sale of the oil and gas in place. Instead, upon examination of the purposes and scope of the capital gains provisions, it was held that the lessor received ordinary income within the meaning of the federal taxing statute.

While the taxpayer constantly assumes the contrary (Br. 12–14), we need only point to the discussion in the Tax Court's opinion (R. 33–41) as illustrating the variety of views among the states on the question whether a growing crop is part of the real estate—a question which, as the Tax Court aptly observed (R. 41), cannot be answered categorically, even in a single jurisdiction, without reference to the context of the particular type of legal problem presented. It is for this reason that the answer to the question here must be found in the meaning of the terms used in the taxing statute.

Furthermore, what local law may regard as inseparable property elements may, from the viewpoint of the taxing statute, involve separable elements giving rise to separate tax consequences. Thus, in *West* v. *Commissioner*, 150 F. 2d 723

(C. A. 5th), certiorari denied, 326 U. S. 795, a conveyance of land together with an interest in the underlying minerals was held taxable as the sale of a capital asset only so far as the surface land was concerned, but to have resulted in the realization of ordinary income to the extent that it involved the granting of rights in the underlying minerals. Again, as we have already observed (p. 18, *supra*), from 1938 through 1941, property of a depreciable nature used in a trade or business was excluded from the capital asset definition, so that where a taxpayer possessed real estate which was used in the trade or business on which depreciable improvements existed, a sale of the entire property was a conversion of a capital asset only so far as the non-depreciable land was concerned, and the depreciable improvements were treated as ordinary assets. *Fackler v. Commissioner*, 133 F. 2d 509, 511 (C. A. 6th); Section 117 (a) (1) of the Revenue Act of 1938, c. 289, 52 Stat. 447, and of the Internal Revenue Code; Article 117–1, Treasury Regulations 101, promulgated under the Revenue Act of 1938, and Section 19.117–1, Treasury Regulations 103, promulgated under the Internal Revenue Code; I. T. 3217, 1938–2 Cum. Bull. 94; I. T. 3246, 1939–1 Cum. Bull. (Part 1) 137. Indeed, if the taxpayer had sold the grove property during the period 1938–1941, the gain attributable to the fruit-bearing trees, which are depreciable prop-

erty, would have been taxed as ordinary income and capital gain would have been limited to the profit realized from the transfer of the land itself. This result, quite clearly, would have followed under the statute as it then existed, regardless of whether California law would have viewed the sale as indivisible.

There is nothing in Section 117 (j) or in its legislative history to indicate that Congress, departing from concepts long employed in the definition of a capital asset, intended to make local rules of law the guiding standard for ascertaining whether particular property is used in a trade or business or whether divisible property elements are involved in a particular transfer. Accordingly, whether California law would classify the growing fruit as an inseparable element of the real estate, is altogether irrelevant to the federal tax question involved in this case. Furthermore, it is not material whether the growing crop is classified as personal or real property under the taxing statute for, as both of the courts below observed (R. 43–44, 131–132), whether regarded as personal or real property, the growing crop is not entitled to the benefits of Section 117 (j) since it was being held primarily for sale to customers, and the exclusion of such property from the definition in Section 117 (j) (1) is equally applicable to both real and personal property.

D. *The Inapplicability of Code Section 117 (j) to Growing Crops Is Confirmed by Subsequent Congressional Action.*—Cumulative support, if more were needed, for the correctness of the decisions below will be found in Section 323 of the Revenue Act of 1951, c. 521, 65 Stat. 452. Section 323 (a) (1) of that Act added to the definition of "property used in the trade or business" in Section 117 (j) (1), so that that section now provides that "Such term also includes * * * unharvested crops to which paragraph (3) is applicable." Section 323 (a) (2) added paragraph (3) to Code Section 117 (j) to provide that where there is an unharvested crop on land which is used in the trade or business and held for more than 6 months, if the crop and the land are sold at the same time and to the same person, "the crop shall be considered as 'property used in the trade or business.'" By Section 323 (c), these amendments were made effective only with respect to sales or exchanges occurring in taxable years after December 31, 1950. Section 323 (b) (1) of the 1951 Act also added Section 24 (f) to the Code, to provide that where an unharvested crop is considered as property having the benefits of Code Section 117 (j), no deduction should be allowed in computing net income (whether or not in the year of the sale) with respect to any expenses attributable to the production of the crop. Section 323 (b) (2) amended Code Section

113 (b) (1) so that the deductions disallowed under Code Section 24 (f) would be added to the basis of the property.[10]

Several significant conclusions are evident from these statutory changes. First, the Committee did *not* state that the amendment was declaratory of existing law, and that the Bureau of Internal

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[10] In explaining these amendments to the Code, the Senate Committee on Finance stated (S. Rep. No. 781, 82d Cong., 1st Sess., pp. 47–48 (1951–2 Cum. Bull. 458, 491–492)):

"Section 117 (j) of the code provides, in effect, that a net gain from sales of properties 'used in the trade or business' of the taxpayer, including 'real property' so used, if held more than 6 months is to be treated as a capital gain. In the case of a net loss, it is treated as an ordinary loss. Where unharvested crops are sold with the land, or unripe fruit is sold together with the land and the trees, a difficult question has arisen as to the proper application of the present law to the unharvested crops or the unripe fruit.

"The Bureau of Internal Revenue has ruled that, whether or not such crops or fruit are regarded as a part of the real estate under local law, they constitute property held 'primarily for sale to customers in the ordinary course of his (the taxpayer's) trade or business' and thus, under the provisions of section 117 (j), any gain on the sale of the unharvested crops or unripe fruit is to be separately determined and treated as ordinary income instead of as a capital gain. In several decisions the Tax Court (with some members dissenting) has taken a similar view, but two district courts have held that such fruits or crops constitute 'property used in the trade or business' so that a gain from a sale of the land, trees, and fruit would be treated as a capital gain with the result that the entire gain from the sale of such property would constitute ordinary income.

"Your committee believes that sales of land together with growing crops or fruit are not such transactions as occur in the ordinary course of business and should thus result in

Revenue had taken an erroneous view of the prior statute. Indeed, the benefits of capital gain treatment were extended, not because the crop is used in a trade or business, but because the sale does not occur in the ordinary course of business—a distinction which is not the standard for other kinds of property. See *Williams* v. *McGowan*, 152 F. 2d 570 (C. A. 2d), involving the sale of an entire business, including the stock in trade. Second, the amendments to the Code, instead of being retroactive, as might be expected if Congress had viewed the new language as being declaratory of existing law, were given a prospec-

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capital gains rather than in ordinary income. Section 323 of the bill so provides.

"Your committee recognizes, however, that when the taxpayer keeps his accounts and makes his returns on the cash receipts and disbursements basis, the expenses of growing the unharvested crop or the unripe fruit will be deducted in full from ordinary income, while the entire proceeds from the sale of the crop, as such, will be viewed as a capital gain. Actually, of course, the true gain in such cases is the difference between that part of the selling price attributable to the crop or fruit and the expenses attributable to its production. Therefore, your committee's bill provides that no deduction shall be allowed which is attributable to the production of such crops or fruit, but that the deductions so disallowed shall be included in the basis of the property for the purpose of computing the capital gain.

"The provisions of this section are applicable to sales or other dispositions occurring in taxable years beginning after December 31, 1950.

"The revenue loss under this provision is expected to be about $3 million annually."

tive application only. While the taxpayer, of course, contends (Br. 29) that it was not necessary to make the statute retroactive, the failure of Congress to do so where growing crops are involved is to be contrasted with the retroactive amendment made by Section 324 of the 1951 Act to extend Code Section 117 (j) to livestock held for breeding or dairy purposes. Third, the extension of capital gain treatment to unharvested crops was accompanied by withdrawing a taxpayer's right to deduct from ordinary income, whether in the same or preceding taxable years, the expenses incurred in the production of the unharvested crop. This plainly indicates that the statute was being extended to embrace a new area—an extension which could not fairly be granted without also altering the right to deduct crop expenses. It stands in marked contrast to what the taxpayer contends was the Congressional intent prior to 1951, namely, that while permitting the crop expenses to be deducted from ordinary income, Congress had already extended capital gain treatment to unharvested crops. Further, the Senate Finance Committee recognized that because of the change in the law (fn. 10, *supra*, p. 40) "The revenue loss * * * is expected to be about $3 million annually." As the court below stated (R. 133): "Here is a clear recognition that § 117 (j) (1) prior to amendment is

as interpreted by the Tax Court and this opinion." [11]

In the light of the foregoing, we submit that when taxpayers first began to urge that the adoption of Code Section 117 (j) operated to extend capital gain treatment to growing crops if transferred to a purchaser in a single sale of the farm land, the Bureau of Internal Revenue properly ruled that the statute did not contemplate such a result: I. T. 3815, 1946–2 Cum. Bull. 30.[12] and the courts below were correct in sustaining this ruling.

The matters discussed above also demonstrate why the contrary decision in *Owen* v. *Commissioner*, 192 F. 2d 1006 (C. A. 5th), and in *McCoy*

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[11] In Miller, *The "Capital Asset" Concept: A Critique of Capital Gains Taxation*, 59 Yale L. J. 837 (1950), referring to Code Section 117 (k), which extended capital gain treatment to timber owners, it is stated (fn. 142, p. 866): "Such legislative favoritism does not imply that the prior judicial interpretations of § 117 (a) were erroneous but indicates merely that the substantial benefits accorded to sales of capital assets are a standing invitation to interested groups with sufficient influence to secure lower taxes for themselves without regard to the policies which supposedly justify the special treatment of capital transactions."

[12] The taxpayer states (Br. 22–23) that prior to the ruling in I. T. 3815, *supra*, a farmer who sold farm land was not required to report as ordinary income the profit allocable to a growing crop. This statement stands unsupported by any ruling, decision, or other authority. Equally unwarranted is the taxpayer's attempt to suggest that I. T. 3815 was a reversal in position (Br. 23) "inspired" by *Williams* v. *McGowan*, 152 F. 2d 570 (C. A. 2d), a decision which is not even mentioned in the ruling.

v. *Commissioner,* 192 F. 2d 486 (C. A. 10th), are erroneous. For example, in the *Owen* case, *supra,* once the court assumed, quite mistakenly, that the operation of Section 117 (j) was conclusively governed by the fact that Florida law characterized the unharvested citrus crop as an inseparable part of the real estate, it was almost inevitable that the incorrect tax result would be reached. Furthermore, it is very difficult to reconcile the court's recognition that the growing fruit was being held (192 F. 2d at p. 1009) "for a potential future sale" with its ultimate conclusion that the fruit was not being held primarily for sale to customers. How property which is being held for even "potential" sale, and only for that purpose, could also be "used" in the trade or business, is a matter which the court does not answer. Also, in the *McCoy* case, *supra,* the court, paying little heed to the statutory exclusion of property held for sale to customers, assumed that an unharvested crop was an inseparable element of the land because Kansas law so regarded it, and that Section 117 (j) applied as well to the crop as to the land.

Other authorities relied on by the taxpayer are not at all persuasive here. Thus, in *Butler Consolidated Coal Co.* v. *Commissioner,* 6 T. C. 183 (Pet. Br. 17–18), the taxpayer was in the business of mining and selling coal. On a sale of coal property, at which the taxpayer had abandoned mining operations many years before, it was held that the coal in place was a capital asset

and that a capital loss was incurred. The decision rested on the ground that the taxpayer there was in the business of mining and selling coal, and was not in the business of selling unmined coal. The situation is not at all comparable to that presented here where the taxpayer's business was growing and selling oranges and where the oranges which were sold, though not fully mature, were grown by the taxpayer. The *Butler* case would have been analogous only if the subject of the sale had included some coal which had been severed but which was not yet in a saleable condition because still uncleaned and unsorted. Had the latter been the situation in the *Butler Coal* case, we believe that the profit attributable to the partially mined coal would have been taxable as ordinary income.

In *Carroll* v. *Commissioner*, 70 F. 2d 806 (C. A. 5th), and *Camp Manufacturing Co.* v. *Commissioner*, 3 T. C. 467 (Pet. Br. 18), the taxpayers had been in the business of cutting timber from their own lands and *fabricating* it into lumber. Sale of the land and growing timber was held to be the sale of a capital asset. Those cases are distinguishable, as the Tax Court pointed out (R. 48), because there the taxpayers were in the business of selling lumber which they had fabricated and were not in the business of growing timber for sale, while here the growing crop represented the efforts of the business in which the taxpayer was engaged.

II

ALTERNATIVELY, THE CROP WAS NOT HELD FOR 6 MONTHS AND CODE SECTION 117 (j) IS NOT APPLICABLE TO EXTEND CAPITAL GAIN TREATMENT TO THE PROFIT

Even if the decisions below should be deemed incorrect in holding that the growing crop did not satisfy the definition of Section 117 (j) (1) because it was not used in the trade or business and because it was being held primarily for sale to customers, there is, as held by the Court of Appeals, an alternative reason why that section is not applicable. That is, no property, whatever its character, can qualify under the Section 117 (j) (1) definition unless it has been held by a taxpayer for at least 6 months. In the present case, the existing orange crop had not been held by the taxpayer for the requisite period and, accordingly, Section 117 (j) (1) is inapplicable.

The earliest point in the year when the fruit crop could possibly be thought of as having an existence is when the blossoms form on the trees. This the Tax Court found to be (R. 26) "in the spring" and the testimony, more precisely, would place the blossoming and the forming of the small fruit in May (R. 80). As a practical matter, however, the annual crop probably starts its existence later, for a considerable portion of the ~~small~~ fruit drops from the trees during May and June, and after that the crop is said to become "set" in the area

where this particular grove was situated. (R. 26.) Thus, whether the fruit is considered as coming into existence at the time of blossoming or later at the time when the crop becomes "set," it is clear that the crop had not been in existence for 6 months and could not have been held by the taxpayer for 6 months on August 10, 1944, when the agreement of sale was concluded or on September 1, 1944, when the purchase price was paid. Accordingly, even if the taxpayer's contention to the effect that the oranges were not being held by her for sale to customers in the ordinary course of her trade or business could be accepted, the fact that the crop had not been held for 6 months prior to the sale would, under the express terms of Section 117 (j), be a complete bar to the application of that section.

CONCLUSION

The decision of the Court of Appeals is correct and should be affirmed.

Respectfully submitted,

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January 1953.

APPENDIX

INTERNAL REVENUE CODE:

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) [as amended by Section 115 (b), Revenue Act of 1941, c. 412, 55 Stat. 687, and Section 151 (a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Definitions.*—As used in this chapter—

(1) *Capital Assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l), or an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, or real property used in the trade or business of the taxpayer;

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(j) [as added by Section 151 (b), Revenue Act of 1942, *supra*, and amended by Section 127 (b), Revenue Act of 1943, c. 63, 58 Stat. 21] *Gains and Losses From In-*

voluntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.—

(1) *Definition of Property used in the Trade or Business.*—For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Such term also includes timber with respect to which subsection (k) (1) or (2) is applicable.

(2) *General Rule.*—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses

from sales or exchanges of capital assets. For the purposes of this paragraph:

(A) In determining under this paragraph whether gains exceed losses, the gains and losses described therein shall be included only if and to the extent taken into account in computing net income, except that subsections (b) and (d) shall not apply.

(B) Losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

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(26 U. S. C. 1946 ed., Sec. 117.)

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